Financial History Review 19.1 (2012), pp. 1–19. © European Association for Banking and Financial History e.V. 2012
doi:10.1017/S0968565011000291

THE PAST MIRROR: NOTES, SURVEYS, DEBATES

The vanishing banker[1]

MARC FLANDREAU
Graduate Institute for International Studies and Development, Geneva
marc.flandreau@graduateinstitute.ch

This article explores the relation between financial crises and economic discourse, focusing on the record of foreign debt crises. I identify a curious migration of discourse across social groups. Discourse that was previously proffered by bankers is now part of the production of economic 'science'. I argue that this migration can be interpreted as an attempt to manage 'speech-liability'.

Keywords: reputation, debt crises, merchant banks, Money Trust, New Deal, subprime crisis

JEL classification: G01, N20.

Perhaps it all goes back to the chapter in Adam Smith's *Wealth of Nation* where he writes about 'b' professions: 'It is not from the benevolence of the butcher, the brewer, or the baker', he argues, 'that we expect our dinner, but from their regard to their own interest.' He then elaborates: 'We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages' (Smith 1776, book I, ch. II). Smith's discussion of the role of self-interest in 'b' professions omitted bankers. Yet bankers face conflicts of virtue that are not really different from those experienced by bakers, brewers, or butchers. Just like them, bankers rely on trust from customers, trust that they have to acquire, maintain and protect. On this account, crises represent infelicitous instances: a natural casualty of a financial crisis may be the word of the banker.

This article will explore how, as a result of this, crises 'make' economic discourse. The conventional focus on crises as events where financial capital destroyed is complemented. Crises become serious, I argue, because they destroy linguistic capital. To see why, recall that the performative role of economic discourse in shaping economic reality has often been emphasised. But few seem to realise that if this is so, then crises have special significance as infelicitous events *par excellence*, with a capacity to

[1] Many thanks to Cécile Bishop and an anonymous referee for detailed comments and encouragement on an earlier draft.

reverberate on discourse. Economic discourse is an asset that has value because of its performative properties. Crises put this capacity to perform at stake. More than anything else, financial crises are therefore crises of speech, a challenge to discourse. The violent indictment of 'conflicts of interest' in public debates following the subprime crisis provides an illustration for the present time. It is not that conflicts of interest become more serious when a crisis happens, nor even that they are 'revealed'. Rather, crises open a breach in former linguistic strategies. As a result, crises create a need for reconstructive discourse, in the same way accidents require reconstructive surgery. I conclude that studying the politics of post-crisis discourse is of utmost importance.

The current crisis is no exception to this trend. It challenges the previous belief, perhaps best captured by Gordon Gekko's diatribe in Oliver Stone's *Wall Street*, that greed would have cleansing properties: that 'greed is good, greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge has marked the upward surge of mankind. And greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the USA.' This discourse has been damaged by the subprime mess and would be hard to proffer before the Financial Crisis Inquiry Commission. We may be observing the first stages of a recomposition of discourse on finance and the market economy. At the same time, since all this is happening right now, it is difficult to identify clearly trends and patterns. A historical perspective may be useful. The current crisis has often been compared to the crisis of 1929. Economists and policymakers have described the policies adopted as fighting the comeback of this fearful crisis. But one relevant comparison with the interwar period has been entirely left out: the way discourse on finance was revolutionised by the Great Depression.

This is a huge topic for a short article. Yet, at the cost of some focus, it is possible to derive a number of important sugggestions regarding how crises make discourse. In this article, I approach this issue through a discussion of the historical evolution of the discourse about bankers' responsibility or conflicts of interests in originating and distributing loans to foreign governments. This focus provides a valuable and colourful entry point. The reason is that talk of foreign government debt is a linguistic microcosm where many species of figures of speech are found. Moreover, crashes have left tangible traces in the shape of parliamentary investigations, which are always the climax of a crisis. In particular, two famous reports concerned with trouble in the foreign bond market, situated in distant points in time, provide a start. These are Britain's *Select Committee on Loans to Foreign States* of 1875 and America's *Senate Committee on Finance on the Sale of Foreign Bonds* of 1931–2, the forerunner hearings to the more popular and broader Pecora investigation on Stock Exchange (mal)practices. These sources, and other secondary and archival material as well, are put to work to suggest that the interwar crisis produced a separation of speech and act where they used to be combined.

I

The market for foreign government debt was started more than 200 years ago in Amsterdam and, as a result, this is where traces of the reputation argument are first found. Fourteen years after Smith published the *Wealth of Nations* Cazenove, a broker, suggested that the reason why certain banks succeeded in this market and distributed larger amounts of loans than their competitors was that they had a reputation. They were careful, and had to be, because investors made their picks on the basis of the confidence which intermediaries inspired. The business of selling foreign government securities to the public was a matter of prudent enterprise and success arose from the 'care, which those houses take to only introduce in the market solid loans and to monitor the respect of all forms', and in particular from avoidance of giving the impression that 'rash business' was involved (see Riley 1980, pp. 39 and 42–3). In other words, banks had to be like Dickens's imagined Tellson banking house, which famously kept young bankers 'unseen like a cheese until they had the full Tellson's flavour and blue-mould upon them' (*A Tale of Two Cities*, p. 53). Self-restraint, even being boring, was the key to success. The reason why bankers or bakers would not cheat customers is not because they did not have a desire to do so – they did. But they had an even bigger desire, which was to increase the number of their customers and for this they had to be boring. Reputation was the philosopher's stone that transmuted the mud of greed into the riches and plenty of veracity. The argument has become common knowledge today, even as bankers look more like Gordon Gekko.

Yet there is nothing natural about the reputation argument. Like any other social object, it was constructed over time – in the instance, 'reputation' was constructed as an antidote to 'conflict of interest'. The biography of the reputation argument is enmeshed with successive reincarnations of the international bond market and subsequent financial disasters. At a broad level, the cycle looks timeless and proceeds according to a familiar sequence: crashes nurture regrets, regrets nurture blame. Concerns arise about greed, greed captures the limelight. Bankers come under public criticism for having originated and distributed poor securities. It is then realised that bankers have made tons of money through underwriting and distribution fees as well as their informed purchases and sales policy. Investors for their part buy high, sell low, bear the loss. Yet this appearance of a pattern conceals much historical variation.

A milestone is the Select Committee on Loans to Foreign States of 1875. The Select Committee was gathered in the middle of a sovereign debt debacle that had about 40 per cent of outstanding securities defaulted, according to various calculations (Suter 1992). The ambiance of the boom is captured in Henry Drummond Wolff's semi-imaginary description of underwriting practices in the 1860s and 1870s (1908). One London financier is informed that a loan is required by some Latin American country. 'The foreign Government, perhaps, has sent an agent to England, or a friend of the Finance Minister is known to be lodging at Morley's

Hotel' in Trafalgar Square. The financier 'of course, knows everything concerning the country'. '"I think it can be done at 52," he soliloquizes, and sends for two confidential brokers. "Can't be done," says one. "It was offered Baring's at 53, and they refused." "Yes, but they volunteered to take it firm at 49," rejoins the other.... "I think it can be done at 52," again soliloquizes the financier, and putting on his hat he makes for Morley's Hotel.' Then there is a dinner attended by 'retired Indian and Colonial officials be-ribboned', a few admirals, a member of a late government. These, Drummond Wolff suggests, are 'all anxious to become Directors of Companies, all counting upon selling the new loan at a premium'. Attending that dinner are also leading investors, stockbrokers, journalists, and a lobbyist described as a 'politician who has perhaps made a hobby in Parliament of the country in question'. An activist minority bondholder (appropriately enough, he turns out to be a clergyman) is also involved. At the end of the dinner 'the diplomatic representative makes speeches in a language utterly unknown to his fellow-guests. The financier ... confides in English equally unintelligible to the Finance Minister's relative that the loan, if successful, will be entirely owing to his – the financier's – abilities; that if unsuccessful, failure will only be attributable to the rotten and bankrupt state of the borrowing country.'[2]

In the actual story, the loan was to Honduras or Costa Rica or Paraguay, which focused much of the Select Committee on Loans to Foreign States' attention. Critically, the crisis raised doubts about the quality (or value) of bankers' speech. It was said that 'by means of exaggerated statements in the prospectus the public have been induced to believe that the material wealth of the contracting State formed a sufficient security for the repayments of the money borrowed'.[3] Companion to this debased talk was the suspicion of excess profits explaining why the Committee did focus on fees. Fees had been kept secret from the public. For Honduras, post-crisis disclosures put them somewhere around 25 per cent of the amount raised by the borrowing state. Even this could only be an approximation because fees were hidden in complex formulas and inflated purchase prices for industrial goods, which the loans were intended to finance. Fees for Costa Rica stood around 10 or 12 per cent. The icing on the cake came when Honduras defaulted and bondholders converged on the offices of the contractor of the loan, the house of Bischoffsheim-Goldschmidt, a continental shop with a London office. They found the doors closed and the banker gone. The Select Committee did summon Mr Bischoffsheim: a health certificate would be produced instead by Freshfield, the City lawyer,[4] but the banker was hiding in Paris.

[2] Drummond Wolff (1908) contains an entertaining account of what Jenks (1927, p. 274) describes as a 'typical loan negotiation of the [eighteen] seventies'.

[3] Report from the Select Committee on Loans to Foreign States, 1875 (hereinafter Report 1875), pp. xliv–xlix.

[4] Report 1875, p. 117.

II

Members of the Select Committee also found evidence of bankers' wrongdoing in market manipulations in what was known as 'price rigging'. Bankers had originated securities without regard to the actual position of the country. They had created a fictitious market, having one broker selling above issue price, and another one buying at that price just to make sure *The Times* would report the security trading at premium, thereby getting investors excited and stirring a market.[5] The argument was eventually picked up in the Select Committee's final report:

> In order to induce the public to lend money upon a totally insufficient security, means have been resorted to which, in their nature and object, were flagrantly deceptive. The price at which the dealings took place in no way represented the value of the stock. It was fixed by the contractor or his agents at a premium, in order to induce the public to believe that the loan was a good investment, or that they would … realize a premium. The public had no means of learning that the contractor was the principal in these transactions… Thus there was no apparent difference between a genuine and a fictitious market.[6]

The important element here is that it was the failure of the market that constituted the wrongdoing.

But wrongdoing had varied across intermediaries, and as a result speech also varied. This is perceptible from the strategies used by the bankers questioned. Baron Erlanger of the eponymous house, who was accused of such dealings when introducing the securities of Costa Rica, claimed this was normal business: the French government, he said, did it for all its public offerings to ensure success.[7] This was true, but then the Baron was also positive that Costa Rica would pay. 'They can and they will if they only see that they must', the Baron (who had also distributed some bizarre Cotton Bonds for the Confederacy during the US Civil War) insisted.[8] Others tried the escape route. A long-time representative of the house of Barings (with the full Baring flavour and blue-mould upon him?) said they would never do such things, but historians have reasons to believe otherwise.[9] As for Nathaniel Meyer de Rothschild, he explained that the distribution of securities during the early placement of a loan had to be made in a careful way, by 'dividing those [investors] that we consider bona fide from those that we consider speculative'. This way you would get rid of the fictitious transactions that surrounded issues and were indeed not a desirable thing. But beyond that, he thought underwriters did what they had to do. He recalled an instance when his grandfather stepped in to make a market for a Neapolitan loan

[5] In his testimony, Herman de Zoete suggests that *The Times* grew so concerned about the practice that it refused to report prices until the full allocation of securities to the public began (Report 1875, pp. 4–16).

[6] Report 1875, p. xlv.

[7] Select Committee, pp. 170–1, Q. 3975 ff.

[8] Select Committee, p. 172.

[9] The evidence in Flandreau and Flores (2012, forthcoming) suggests that prestigious brands such as Barings made efforts to ensure the success of their issues.

that had been 'badly placed'. So much for the 'natural' operation of the market and the need to avoid tampering: the wall between sound practice and market rigging, between good deeds and evil doing, between reputation and conflict of interest, once it was brought into the daylight, was a slim and translucent one.[10] Samuel Herman de Zoete, chairman of the Committee of the London Stock Exchange, recognised this when he was asked about market manipulations and answered: 'It is very difficult to form an opinion upon that.'[11]

The point was that speech and credit were banker dependent. The old rhyme 'in speculation your language you must choose: it's an investment if you win, but a gamble if you lose' was compounded by the question of who had been in charge. Statistical work shows that speculation in foreign government bonds was an investment with Rothschilds, but a gamble with Erlangers.[12] The rhyme may be lost, but an insight is gained: the Select Committee displayed the competition of speech that was the backbone of the British financial system and manifested the greater performativity of Rothschilds' word. The dramaturgy of the hearings also suggested that the outcome was preordained. Rothschild was one of the last to be questioned and his testimony played the role of a catharsis (his recommendations were followed). Critically, Rothschild laid the blame – for greediness – on those investors who had put their money with governments, yielding fabulous returns, through contractors, daring to sell such bonds. The imprudent buyers were the ones who deserved punishment – and they had already been punished. The mass was said, and the crisis was recycled to illustrate the greater competitive value of the word of some bankers: those really in charge.

III

About 60 years later, the Senate Committee on Finance Hearings on the Sale of Foreign Bonds was convened in Washington to deal with a looming global bond disaster that would eventually leave deep scars in the international financial system. Similar concerns and a similar wording were observed, except of course that British English and American English are different languages. Again, default rates would be somewhere around 40 per cent. In the fall of 1931, as the international bond market evaporated, New York bankers were grilled by a group of senators. Hiram Johnston, a Republican maverick from California, former leader of the Progressive Party, and supporter of Roosevelt in the 1932 presidential election campaign, led the charge. Accusations of intentional over-lending, deceptive prospectuses and

[10] Select Committee, p. 267, Q. 5775.

[11] Select Committee, pp. 5–6, Q. 129. The question was: 'Supposing this is done by the agent of the [underwriter] simply to launch the loan, and he authorizes one broker to buy, and another to sell, at a price which is a premium, do you think that is a healthy state of things to exist?'

[12] See Flandreau and Flores (2009) for a study of how Rothschilds established their connection with successful loans in the early nineteenth century, a position that was maintained afterwards according to results in Flandreau *et al.* (2009).

price rigging again came up. The public wanted to know about price manipulation, which was said to be rampant. The public wanted to know about briberies and insider lending.

Again, the problem of secrecy of bankers' profits from foreign loans was paramount. Large fees were said to have been associated with wrongdoing. And when the price of foreign bonds plummeted in New York, resentment against bankers became acute. In the words of one contemporary observer: 'The heavy drop in prices of German bonds following the default of many South American loans has aroused a bitter feeling against the "international banker".' One factor which particularly irritated the public was the belief that the bankers derived 'excessive profits from the sale of these bonds while investors who had to resell them suffered severe losses'.[13] And there was the familiar worry about bankers' bonuses, which were high when the market was low.

It thus became a principal task of the Senate Hearings, as it had been for the Select Committee 60 years earlier, to collect information on fees for the placement of foreign debt. Among the records that were then registered was the 'Lower Austrian Hydro-Electric Power', a bond backed by the Austrian government issued in August 1924. The fee pocketed by the syndicate led by F. J. Lisman was 24 per cent. This was a somewhat extreme number and the Austrian Hydro-Electric Power was an obscure concern. The bond would default in August 1932. Other instances included a Polish government loan of 1925, introduced by Dillon & Reed, for a 10 per cent commission. Numbers were thus similar to those discovered by the Select Committee. In one loan to Peru, underwritten by the house of Seligman, the fees included a 'surcharge' to be paid to a 'group of promoters', and it was learned that this group included the son of President Leguia, who received half a million US dollars for this.[14] All Seligman's loans to Peru were in arrears when the Senate Committee first met and the Austrian and Polish loans followed soon after. Leguia's son went to Paris with the proceeds, where all the swindled money must have ended up.

This is where 'Tom, Dick and Harry' entered the scene. While questioning Otto H. Kahn, of the banking house of Kuhn, Loeb & Co, Senate Committee member Thomas Gore from Oklahoma claimed that bankers had a moral liability towards the public to whom they sold the bonds. These bonds, he said, were bought 'by Tom, Dick and Harry… without any reference to the solidity or the solvency of the bonds . . . but entirely on the faith of the house issuing them in New York'.[15] The question became: who's taking care of Tom, Dick and Harry?[16] Comparisons

13 Foreword to Kuczinski (1932).

14 The information surfaced with the help of President Leguia's successor, or rather the one who toppled him from power, who used this as a way to demonstrate the odious nature of the debts.

15 US Senate Hearings 1932, p. 352.

16 Note that it is not entirely clear that Tom, Dick and Harry needed someone to take care of them. Estimates in Morrow (1927) suggest that the median purchase order they had placed on the market was not small, about US$3,000. If we assume some minimal diversification, then Tom, Dick and Harry were probably richer than your average Joe.

between banking and other branches of business were made. Smith's baker was put to rest for this was still prohibition time and metaphors needed an update: Senator Connally declared to Charles Mitchell, CEO of National City Bank, that 'with reference to foreign bonds, you are like the saloon keeper who never drank. His whiskey was made to sell, not to drink.'[17] US bankers had no qualms about being compared with merchants or even saloon keepers. Mitchell answered that 'with respect to bonds generally, we are merchants'.[18] But bankers claimed they deserved respect, and some argued that faith in the banker was the only measuring rod for the investor.

Poring through the 2,179 pages of evidence collected by the Senate Committee, one observes the emergence of an articulated discourse on bankers' responsibility. This discourse did not stem from nothing: its basics had been spelt out earlier and they were already part of the conventional wisdom among British bankers. But US bankers reacted perhaps more aggressively than their British counterparts in the 1870s. This may have had to do with being Americans, but the bankers' reaction also reflected the issues at stake. The rumbles on Main Street against bankers were about to be picked up by Franklin Delano Roosevelt's presidential campaign. In addition, the Wall Street vs Main Street theme also had a history. Ever since Pujo's inquiry into the Money Trust of 1912 – a grouping of financial interests and interlocking directorates at the heart of which was the house of J. P. Morgan – and Louis Brandeis' questioning of what bankers do with 'Other People's Money', relations between America and its New York bankers had not been peaceful.[19] The financial crisis that followed the crash of 1929 put financiers at a disadvantage and now that the market collapse was morphing into a full-scale debt crisis, Main Street, and soon Washington, was punching hard. There was also a concern amongst the public that the Republican administration had encouraged, supported and nursed the Wall Street establishment, and with elections approaching, politicians were making sure they were heard. This may have forced Wall Street bankers to kick back. The matter, as it emerged in the 1930s, was thus far more political than was the case in the less democratic British society of the Victorian era, and as a result it received much political attention, ensuring a long career for Tom, Dick and Harry.

IV

Bankers went into much detail to explain why fees looked the way they did. They explained that larger issues commanded lower fees because of scale economies: the work was about the same as for small ones. They explained that new public offerings commanded higher fees because new issues demanded more expensive roadshows or, in the flowery language of the time, they involved more of a process of

[17] US Senate Hearings 1932, p. 81. The metaphor turned banks into some kind of speakeasy, and the new word 'banksters' was just one step away.

[18] Ibid.

[19] Ibid.

'enlightenment and explanation'.[20] Bankers especially explained why they had an interest in bonds meeting ends and could not just wash their hands after an issue had succeeded. According to Otto Kahn: 'We have an interest in the bonds until they are repaid according to their due date. We consider that we are under a permanent moral liability to do what we can for the protection of these bonds.'[21] A successful issue did not relieve the banker of this moral liability: 'The question of success or non success of an issue is one of the public's response. Though being relieved from our legal responsibility, the matter of our moral responsibility and of prestige and of interest as issuing houses remains.'[22]

The main concern of the banker, they said, was to price securities properly. Wrong pricing would not generate higher revenue. It would damage reputation. They took care, Kahn explained, to bring to the market only loans which could sustain economic development, for only this would increase the likelihood of future repayments. All these accusations of debt un-sustainability were missing the point: bankers were concerned with bringing to the market high-quality loans. He insisted that Kuhn & Loeb declined military loans.[23] Just as Cazenove had suggested 150 years earlier, riskier places and rash competition were avoided by serious houses: 'It is a strict tradition of my house not so to compete either in South America or elsewhere.'[24] Being boring, again.

The public, Kahn felt, had been under the wrong impression regarding price manipulations. Very much like Nathaniel de Rothschild before the Select Committee, he argued that there were cases where bankers had to step in to make sure things worked out according to plan. He recalled the case of a loan to the state-guaranteed Mortgage Bank of Chile when Kuhn and Loeb 'went into the market, and bought bonds [themselves]'.[25] In fact, the process of underwriting created a contingent liability. If there is an 'unjustifiable decline in bonds, if there is not a fair market for the bonds' the underwriter ought to go into the market and permit those who want to walk out to do so. This Kuhn and Loeb had done 'more than once'.[26] Bankers had to treat bonds they had sponsored as open-ended investments.

Otto Kahn concluded, with lyrical tones, that a banker was like any other merchant, 'except that … the banker is called upon to exercise a greater degree of care than pretty nearly anyone else who is dealing with the public, because he is dealing

20 US Senate Hearings 1932. For the effect of size, see Kahn's testimony, p. 118; Seligman's testimony, p. 1271: 'The expenses in connection with the selling of a small loan necessitate a wider spread' [by which they mean spread between buying and selling price, or fee]. For initial public offerings being more costly than seasoned ones, see Lamont's testimony, pp. 19–20.

21 Otto Kahn, US Senate Hearings 1932, p. 135.

22 Ibid., p. 387.

23 Ibid., p. 357.

24 Ibid., p. 343.

25 Ibid., p. 387.

26 Ibid., p. 135.

with a commodity as to which he is considered to be an expert adviser and as to which many people rely on his integrity'. 'And judgment?' pushed Senator Hiram Johnson. But Otto Kahn was already high:

> His integrity and judgment… He must resolutely decline, whatever be the monetary inducement, to attach that trademark and that responsibility to any securities as to the soundness of which there is, or ought to be, any doubt in his own mind. If he does not do all that, he is not the kind of banker that deserves to live.[27]

Otto Kahn's Oheka Castle (from *O*tto *He*rmann *Ka*hn) on Long Island suggested that if a banker did all this, he deserved to live pretty well.

The fact was that pretty much like Rothschilds, which had had the best record in foreign government debt, senior houses such as Morgans had a quite impeccable one, as they were never tired of pointing out. The problem, they emphasised, was with other bankers' devalued talk. Despite all their efforts, the New York banking aristocracy was losing rhetorical ground. In April 1932 a second commission was appointed, this time by the Senate Committee on Banking and Currency, and charged with investigating stock exchange practices. In January 1933, as FDR was pledging to drive the 'money changers' out of the Temple, Ferdinand Pecora, an assistant district attorney for New York County, was hired as chief counsel to write the final report. Taking advantage of the accusation from Democrats that the Committee on Banking and Currency had been too lenient with bankers, Pecora raised the stakes. He claimed that more evidence was needed; and, after receiving backing from FDR, he was allowed to examine key witnesses. Thomas Lamont of J. P. Morgan and Otto Kahn from Kuhn and Loeb were again summoned. The way Pecora dealt with National City Bank's Charles Mitchell made headlines, eventually forcing the CEO into resignation. Using threats of subpoena, Pecora managed to produce the Morgan balance sheet. Pecora established himself as the slayer of the Morgans and Mitchells of this world, transforming him into a leading public figure.

In his 1939 memoirs, *Wall Street under Oath*, Pecora portrayed his action as a chief inspiration for the sweeping regulatory reform of the 1930s that included the Glass–Steagall Banking Act of 1933 (separating commercial and investment banking), the Securities Act of 1933 (setting penalties for filing false information about stock offerings), and the Securities Exchange Act of 1934 (which formed the SEC, to regulate the stock exchanges, and of which Pecora was appointed commissioner). Indeed, the New Deal's financial Acts had sent the bankers into the ropes, and they would not have been possible if a process of devaluation of all bankers' talk had not been implemented first, something that Pecora did, with FDR's support. What had changed compared to the British precedent was that prestigious bankers had not been conferred the right to use the crisis as a performative event. They were not allowed the opportunity to demonstrate that the crisis revealed a quite different range of behaviour and language across financial intermediaries. They were not left

[27] Ibid., p. 343.

with the political opportunity to recycle the event for their own benefit as makers of discourse. And this explains why Pecora, to the surprise of later observers, could focus on sins venial.[28] The inference must be that the extent to which economic outcomes are infelicitous is really a political construction.

V

This paved the way for new ways of writing and talking about bankers and finance. A large degree of distrust in private firms prevailed. The post-war order fashioned by the likes of John Maynard Keynes in the UK or Harry Dexter White in the US emphasised a need for regulatory intervention. The notion that a large banking or financial concern would be disciplined by its desire to remain in place would have been dismissed with a shrug. Wasn't the interwar history a vivid proof that this was not true? The whole regulatory architecture that had been put in place during that time was conventionally, if perhaps inadequately, described as a response to the interwar debacle. It was thus conceived as a legacy of the private economy's failure to manage itself. Bankers had failed economically and they had failed politically. The intellectual case followed suit. Bankers retired into mute distinction while they glanced across from the limousine.

From this high point, a gradual transformation occurred. It started in the background, and was not discernible at first. In 1950, Pecora felt that he could run for Mayor of New York City, but he was not successful. Then, in 1954, the 'corrected opinion' of Harold Medina in *United States of America* v. *Henry S. Morgan, Harold Stanley et al.* brought to a halt two decades of legal and congressional pestering of bankers. This was also the time when Joseph McCarthy found that the real enemies of America were not the bankers but rather people inside the US government. More fundamentally, a process of migration of arguments on the efficiency of greed occurred: an inherent feature of bankers' discourse in the interwar years found its way into the academic vernacular of the economics profession thereafter. This migration opened up valuable possibilities. In the political climate resulting from the ideological threat of communism during the Cold War, greed could not have been high profile and Gordon Gekko was a distant act. However, something could be said for well-conceived self-interest. What is conflict of interest for a banker is scientific discourse for an economist, and this is how the door was opened. In other words, economists performed a process of purification of bankers' discourse.

The result was a progressive reconstruction of discourse. It did not take place in the banking profession. As bankers walked away from the argument on greed, economists took over. They brought their stuff with them – models, data, editors and referees – and started making themselves at home. It is not easy to pin down the point where the changeover took place. Academia was the hotbed where arguments once voiced by

[28] See Huertas and Silverman (1986) for a thorough discussion of Mitchell's indictment.

bankers before the Senate Committee were spawned. As it turned out, new economics, as it flourished in the 1970s after the Keynesian ice age of macro-modelling, was to provide fertile ground for arguments about corporate responsibility. The profession began to focus far more on the fine shades of strategic interactions that are involved when studying credibility. It was realised that if you fooled one thousand persons once you would be unlikely to succeed again – in fact, if you had the slightest reason to fool them in the first place, you would not even manage to achieve that much, for they would second-guess you. The argument received a name (rational expectations) and a Nobel Prize (in 1995). But then, if the argument were true, bankers in the 1870s, in the 1920s or in the 2000s could not be all liars all the time.

VI

But by the time Oliver Stone's movie *Wall Street* was released, economists had become very much in love with greed. The reconstruction of greed as something one could bank on was a multipronged effort and it is impossible to summarise the process here, given space constraints. However, we can focus on three milestones. Each one represented one bit of the full argument and taken together they summarise nicely the main stages in the emergence of this new wisdom. Each was represented by a popular 'model' – the economic word for narrative.

The appropriation of the arguments used by bankers in the interwar period started in an unlikely place. George Akerlof's tale of a 'market for lemons' described the difficulties encountered in trading used cars. Because sellers know roughly how bad the cars they sell are but prospective buyers don't, the very existence of such a market is difficult to sustain. Sellers will set a price buyers are not prepared to pay, because buyers discount the risk of being sold a bad car. But at the low price, which fully covers buyers for the risk of getting a lemon, only bad cars would get sold. One interpretation of Akerlof's argument is that only the market for lemons can prosper, because it is a market that everybody can understand (Akerlof 1970). At the same time, because the market for lemons is where the maximum uncertainty exists, it is likely that such a market would be shallow. In the end, Akerlof suggested, the whole foundations of the exchange economy are fragile.

The lemons story permitted the study of a wide array of new problems. Once the difficulties identified by Akerlof were recognised as challenges to the functioning of a normal trading system, economists began exploring the various solutions that markets design to deal with them. Carl Shapiro was among the first researchers to take a look at the interactions between the lemons problem and reputation, providing a second building block (Shapiro 1983). Whereas Akerlof's story was one in which there was no way to trade in good products, Shapiro suggested that investment in reputation could permit the emergence of a market for quality. The reasoning (very similar to the claims of interwar bankers) was that rational agents would find their interest in selling high-quality products because they would secure higher revenues. This could work as follows: sellers would invest in reputation by behaving well and this would make it costly for them to cheat the public. The reason is that cheating would destroy earlier investment in reputation. This would be a credible strategy, because we, as customers, would realise that, in Smith's words, it is not from the benevolence of the seller that we should expect to receive high-quality goods but from their regard for their own interest. People would then be prepared to pay more for quality, and this would justify the initial investment and beyond. Thus, to the extent that some market power and a sufficiently long time horizon are available, high-quality goods can be traded.

The last stage in the consolidation of the theory is associated with the work of Douglas Diamond, who expanded on Shapiro's intuition. Shapiro had shown that there was a connection between market power and quality. Diamond furthered the reasoning by studying in greater detail the strategic implications of this notion, looking at how reputation is secured (Diamond 1989). His story was meant to suggest that over time, once a good reputation is acquired, it provides improved incentives for disciplining behaviour. Unlike Akerlof's, the paper talked of debt and the financial system: dealers in used cars were left behind.

For financial economics, Diamond's model implied that alternative means to foster reputation or to establish it more rapidly could be considered. This became a kind of 'folk theorem' (i.e. everybody's result), which dozens of papers rediscovered independently. Financial economists began emphasising that a bank's capital or its market share, or more generally anything that the financial institution could lose in case of treachery, could serve to discipline decision makers. Size came back not as the hallmark of market abuse painted in the 1900s and 1930s, but as a good housekeeping seal of approval. Provided with a long enough time horizon and with a large enough market share, we could trust big financial conglomerates to ensure that by pursuing their own interest they would best serve their customers – and us all.

From then on, models started spawning that suggested we could trust the long-lived large firms to monitor 'themselves and their own' because they had the motives to accumulate and retain a critical mass of reputation capital. History was enrolled in the process, too. Revisionist accounts of historical experience with financial concentration became an important aspect of the intellectual revolution. The outcome was that scholars started suggesting that bankers had not done so badly. The time was ripe for a rediscovery of the Money Trust.

Economic historian and long-time Larry Summers' co-author Bradford DeLong took care of the harvest. In a 1991 article ('Did J. P. Morgan's men's add value? An economist's perspective on financial capitalism') he sought to provide a 'modern' perspective on the early twentieth-century debates on the 'Money Trust' (DeLong 1991). When contemporaries had worried over the monopoly power of J. P. Morgan and associated investment banks, DeLong suggested that high concentration in investment banking may have played a positive role in supporting America's 'financial capitalism' in its early days. This was because of the familiar argument that a bank with a large market share would reap proportionate benefits conditional upon having a good name. If reputations were vulnerable, large banks would find it most profitable in the long run to strive to be above suspicion. According to DeLong, the Money Trust would refuse to 'imperil [its] reputation for the sake of higher short-run profits in any one deal as long as the finance industry's future and its own market share appear secure'. By contrast, 'a firm with a small market share would decide to "cash in" its reputation by luring investors into a profitable deal that is unsound'.[29] The following exchange during the already discussed Senate Committee's examination of Otto Kahn provides a counterpart. At one stage, an examiner said something about allegations that poor small banks had been arm-twisted by large nasty ones into distributing bad securities, for fear of being excluded from future operations. To this the (large) banker answered, cautiously: 'the fact that bankers are little does not in itself make them any more virtuous than others who are less little'.[30] While significantly more explicit and vibrant than Kahn's terse reference to little bankers who are not any more virtuous than others who are less little, DeLong's argument is not altogether different.

DeLong thus concluded that J. P. Morgan's men did more economic good than harm. No doubt, JP was greedy. No doubt, it was driven by self-interest. But his conclusion was that J. P. Morgan's men, by sitting on the board of companies and steering them to success, yielded big benefits. They created value through signalling and control.[31] The Trust could quickly replace managers whose performance was unsatisfactory and signal to ultimate investors that a company was well managed and sound. In the end, greed would not only save Teldar Paper, but it had already saved that other malfunctioning corporation called the Money Trust.

Little by little, the rational, matter-of-fact utterances of Adam Smith about bakers, butchers and brewers have received the identifiable hallmark of economics as we know it today, with their ring of complacent cynicism. The inevitable concern for the motivations of the merchant who sells bread, or meat, or beer, with which we feed our bodies, focused people's minds and discussions. It became a reason for reassurance through a process which is hard to describe as anything other than sublimation. This, and the related narratives that went parading as a result under the flag of 'modern' economics, played a powerful symbolic role in permitting the regulatory transformations that have unleashed the American and global financial system in the last quarter of a century.[32] Whatever had been the initial motivations for introducing the regulation of the 1930s, and whatever their relevance or irrelevance then (still a matter for historians to decide), the new generation of economists believed they sounded *passé* in a world where financial institutions could take care of themselves, or face the prospect of dying. Undoubtedly, the reconstruction of bankers' discourse

[29] For this and for much of the language in this paragraph, see DeLong (1991).

[30] US Senate Hearings 1932, p. 394.

[31] 'In 1911–12 the presence on one's board of directors of a partner in J. P. Morgan and Co. added about 30 percent to common stock equity value, and about 15 percent to the total market value of the firm.' DeLong's computations have been challenged by British scholars. See e.g. Hannah (2007) for a critical discussion of De Long's estimates; also Frydman and Hilt (2010).

[32] For an illustration of the 'discovery' of the weak empirical foundations of Glass-Steagall, see Kroszner and Rajan (1994)

in modern economists' language was the posthumous triumph of J. P. Morgan and their people over Washington and the lawmakers in the Pujo Committee and Pecora hearings.

VII

That the battle was won on the turf of economics is not anecdotal. As already suggested, bankers had repeatedly tried to sell the notion that they could act as benevolent trustees. The matter came up, appropriately, during a meeting that occurred between Thomas W. Lamont, the J. P. Morgan partner, and Louis D. Brandeis, the author of the anti-Morgan pamphlet *Other People's Money*. The meeting took place in New York on 2 December 1913, at the University Club, and its minutes transcribed from memory have been kept at the Baker Library in Harvard. Many aspects of the Money Trust were reviewed during the long conversation.[33] At one point, an intriguing exchange took place. This was when Lamont (unsuccessfully) encouraged Brandeis to consider, as a theoretical possibility, that the conflict of interest on which the lawyer had cast his sight was manageable:

> TWL: Does it occur to you Mr Brandeis, that possibly when men are put in the position of trustees they may prove to be more scrupulous if they have some possible interest in both sides of the question, than if they were exclusively on one side?
>
> LDB: No that does not occur to me Mr Lamont. I think the relationship is an impossible one … In the very nature of things, a man cannot argue for and against.[34]

This exchange provides a 1913 response to theories that were yet to be articulated – theories that have come into the mainstream of economic discourse during a much more recent period. Lamont's argument was nothing but a preview of DeLong's defence of the Money Trust. The trustee can act in proper ways if he has some 'skin in the game'. Brandeis' outright rebuttal of the argument is what is intriguing. Of course, Brandeis did have the needed intellectual sophistication to 'understand' the 'logic' of the argument. His insistence that such a thought did not occur to him, on the other hand, suggests that his reasoning was operating in a totally different space than where the banker was trying to push him.

The discussion of the Money Trust he provided in *Other People's Money* gives indications of what was on Brandeis' mind. First there was the principle, legal, and not economic, that no one can be the servant of two masters. The banker is attending to his interest and to that of his customer, and this is already one issue. Second, Brandeis was concerned with the growth of a financial superpower that would escape political control and threaten American democracy. The Money Trust and J. P. Morgan, he argued, represented precisely that kind of risk. In the world of

[33] Lamont's Papers, 84–16. As usual, the reputation argument came up several times, for instance, when Lamont's argued: 'We give our best advice on the financial policy, looking both backward and forward over a series of years, for the purpose of building up and entrenching the company's credit.'

[34] Lamont's Papers, 84–16, p. 10.

economists, the two problems are seen as taking care of one another – the banking superpower provides a reason for moderation and limits the agency (in the language of economists) or trustee (in the language of lawyers) problem. This 'solution', which is not unlike humorous proposals to fill the hole in the ozone layer with nuclear waste, was operating in an impossible world, in the sense of mathematicians, or perhaps linguists: namely, a world with no foundations.

This explains why Brandeis, contrary to later suggestions, did not discount the possibility that such an arrangement be 'efficient', and actually, *Other People's Money* has a whole section where he addresses this very question (he was sceptical), as other scholars have since then.[35] But the important element, for him and for us, was that this efficiency was meaningless. For a while, Brandeis' new rhetoric broke on bankers' deeply entrenched positions and their control of the media, of the US Congress and, later on, of the US presidency. This explains why the Great Depression ended up being epoch making. The financial catastrophe that ensued was the vindication of Brandeisian views that the world that had been built was without foundations. For bankers' narratives that all was well in the world of agency, and that skin in the game and market power would ensure proper treatment of customers, the crash of 1929 and the credit and debt crisis of the early 1930s were infelicitous. With reputation now gone or shaken, the Brandeisian narrative revisited agency problems and replaced the bankers' reassurances that they were being careful with a new emphasis on 'conflicts of interest'.[36]

VIII

So far however, I have only aligned a number of findings, like pebbles brought back from a long walk on the beach. It is time to draw the tale to a close. One striking aspect of current inquiries is their somewhat different focus compared to earlier experiences. While the Select Committee of 1875 and the Senate Committee of 1931–2 were explicitly concerned with examining bankers' wrongdoing, such blunt references have all but disappeared in the mandates of their modern counterparts. The incredibly long list of assignments that have fallen upon the shoulders of the Financial Crisis Inquiry Commission does not include clear requests to investigate the behaviour of investment banks. Many other items refer instead to problems of regulation, regulatory arbitrage and flawed incentives. Its mandate is to 'examine the causes of the current financial and economic crisis in the United States'. This includes, along with more than 20 other items, 'lending practices and securitization, including the originate-to-distribute model for extending credit and transferring risk' (item 9) and 'the quality of due diligence undertaken by financial institutions' (item 22). Likewise, hearings that have taken place so far were more concerned with trying to

[35] Brandeis ([1913] 1933), 'How bankers arrest development', pp. 102ff. See also Hannah (2007).

[36] For an excellent survey of the relations between Washington and Wall Street during the 1930s, see Carosso (1970).

establish wrongdoing in certain specific instances, rather than a general pattern. In any case, the conversation is still conducted in terms of efficiency and performance, and, as a result, it is still structured by the former migration of bankers' discourse into the language of economics.

This should encourage investment rather than divestment. We should collectively aim at widening economists' language (meaning, we should be ready to consider issues that are broader than the computation of local maxima) and take advantage of this crisis of discourse to extend perspectives. Just as the interwar debacle disqualified bankers' narratives, the market collapse that brought down Lehman brothers has questioned economists' narratives. This has come to be recognised within the economic profession itself, at least in the first hours of the panic. For instance, Daron Acemoglu, an MIT economist, provided an early characterisation of the subprime crisis as being the fall-out of what I have called the reconstruction of bankers' discourse as the language of economics:

> Our logic and models suggested that even if we could not trust individuals, particularly when information was imperfect and regulation lacklustre, we could trust the long-lived large firms – companies such as the Enrons, the Bear Stearns, the Merrill Lynchs, and the Lehman Brothers of this world – to monitor themselves and their own because they had accumulated sufficient reputation capital. Our faith in long-lived large organisations was shaken but still standing after the accounting scandals in Enron and other giants of the early 2000s. It may now have suffered the death blow. (Acemoglu 2009, pp. 2–3)

In other words, while a patient reconstruction had us almost ready to believe that bigger is better, we learn that this may not be the case always and everywhere and that, when the system fails, big financial groups are just this – big powers that cannot be controlled any more. To paraphrase Otto Kahn, we have now to come to grips with the fact that bankers being big does not in itself make them any more virtuous than others who are less big. Surprising as it sounds, the belief in the long-lived large firm was the ghost of words spoken by deceased bankers.

It should be by now clear that a main lesson from my discussion is that the situation today is quite different from that in the 1930s. The availability of the legal language articulated by Brandeis a generation before the interwar crisis cooperated with FDR's decision to damage the influence of J. P. Morgan to produce a revolution in speech. This revolution, I have suggested, had little to do with the event of the crisis itself, as comparison with the outcome of the British 'rehearsal' of the 1870s shows. An open question is what is going to happen to economists' discourse as a result of the current crisis. A British-type outcome is not altogether implausible, although one cannot see how the current event can be recycled in support of earlier mainline economic rhetoric.

This observation also underscores the role of different financial gatekeeping technologies before and after the Great Depression, as identified for instance in my work with Flores, Gaillard and Nieto-Parra (Flandreau *et al.* 2009). In the case of the two public inquiries used in this article, the main gatekeepers were the investment and merchant banks, whereas in the recent period a third player was added to the story – the credit ratings agencies. In practice, these have performed the function (useful, from the bankers point of view) of diverting the flow of public opprobium away from the bankers. This is not at all surprising given that the rise of rating agencies during the 1930s had little to do with their performance at the time (Moody's suddenly downgraded 80 per cent of sovereign debt in the week following the sterling crisis in September 1931), and much to do with regulatory intervention in the US to assuage fears of conflicts of interest among issue bankers (Flandreau *et al.* 2011). Likewise, the Securities Act of 1933 created a situation of 'sellers beware' that encouraged underwriters to develop business practices that would minimise liability. Being able to rely on the 'independent' grades delivered by nationally recognised rating agencies had obvious virtues. In sum, the regulatory regime that emerged after the New Deal cut the mechanism whereby bankers' actions had repeatedly been brought into question: we hear here and there accusations against Goldman Sachs, but they are a trifle compared to historical counterparts. The amorphous contours of the entities targeted by the Occupy movement ('Wall Street') illustrate nicely the difficulty that critics find today in identifying a culprit. This may not be unrelated to the role played by economics today in obfuscating responsibilities.

Finally, there is no doubt that rating agencies played a critical role in spreading the perception that uncertainty can be turned into objectivised risk by wholesale trading in a market for contingent claims: everything would get a 'grade' – a price. This relieved intermediaries of the need to accumulate capital to back up their reputational commitment to the securities they issued. In this version of the 'wisdom of crowds' argument, rating agencies may have provided the context and actual force that permitted the appropriation of the 'greed discourse' by economics – without which the theoretical reconstructions of the 1970s and 1980s could not take place. It may not be entirely surprising, therefore, that an important discussion has just begun on rating agencies, the role they have played in the current crisis, and the role they should play in a possibly reconstructed international financial system.

Submitted: 30 August 2011
Revised version submitted: 18 November 2011
Accepted: 24 November 2011

References

ACEMOGLU, D. (2009). The crisis of 2008: structural lessons for and from economics. CEPR Policy Insight No. 28.

AKERLOF, G. A. (1970). The market for 'lemons': quality uncertainty and the market mechanism. *Quarterly Journal of Economics*, **84**(3), pp. 488–500.

BRANDEIS, L. D. ([1913] 1933). *Other People's Money and How Bankers Use It*. New York: Jackett Library.

CAROSSO, V. P. (1970). Washington and Wall Street: the New Deal and investment bankers, 1933–1940. *Business History Review*, **44**(4), pp. 425–45.

DELONG, B. (1991). Did J. P. Morgan's men add value? An economist's perspective on financial capitalism. In P. Temin (ed.), *Inside the Business Enterprise: Historical Perspectives on the Use of Information*. Chicago: University of Chicago Press, pp. 205–36.
DIAMOND, D. W. (1989). Reputation acquisition in debt markets. *Journal of Political Economy*, **97**(4), pp. 828–62.
DICKENS, C. (1859). *A Tale of Two Cities*. London: Chapman and Hall.
DRUMMOND WOLFF, H. (1908). *Rambling Recollections*. London: Macmillan, 1908.
FLANDREAU, M. and FLORES, J. (2009). Bonds and brands: foundations of sovereign debt markets 1820–1930. *The Journal of Economic History*, **69**(3), pp. 646–84.
FLANDREAU, M. and FLORES, J. (2012). Bondholders vs bondsellers: relationship banking and conditionality lending in the London market for government debt, 1815–1913. *European Review of Economic History*, forthcoming.
FLANDREAU, M., FLORES, J., GAILLARD, N. and NIETO-PARRA, S. (2009). The end of gatekeeping: underwriters and the quality of sovereign debt markets, 1815–2007. In L. Reichlin and K. West (eds.), *NBER International Seminar on Macroeconomics*, vol. 6. Chicago: University of Chicago Press.
FLANDREAU, M., GAILLARD, N. and PACKER, F. (2011). To err is human: US rating agencies and the interwar foreign government debt crisis. *European Review of Economic History*, **15**, pp. 495–538.
FRYDMAN, C. and HILT, E. (2010). Predators or watchdogs? Bankers on corporate boards in the era of finance capitalism. Working paper.
HANNAH, L. (2007). What did Morgan men really do? CIRJE-F-465 working paper, University of Tokyo.
HUERTAS, T. F. and SILVERMAN, J. L. (1986). Charles E. Mitchell: scapegoat of the crash? *Business History Review*, **60**(1), pp. 81–103.
JENKS, L. H. (1927). *The Migration of British Capital to 1875*. London: Thomas Nelson.
KROSZNER, R. and RAJAN, R. (1994). Is the Glass-Steagall Act justified? A study of the US experience with universal banking before 1933. *American Economic Review*, **84**(4), pp. 810–32.
KUCZINSKI, R. (1932). *Bankers' Profits from German Loans*. Washington: Brookings.
MORROW, D. W. (1927). Who buys foreign bonds? *Foreign Affairs*, January.
RILEY, J. C. (1980). *International Government Finance and the Amsterdam Capital Market*, 1740–1815. Cambridge: Cambridge University Press.
SHAPIRO, C. (1983). Premiums for high quality products as returns to reputations. *Quarterly Journal of Economics*, **98**(4), pp. 659–79.
SMITH, A. (1776). *An Inquiry into the Nature and Causes of the Wealth of Nations*. London: Strahan and Cadell.
SUTER, CH. (1992). *Debt Cycles in the World-Economy: Foreign Loans, Financial Crises, and Debt Settlements, 1820–1990*. Boulder: Westview.

Sources

Lamont's Papers: Thomas W. Lamont's Papers, Baker Library, Harvard University.
Select Committee (1875): *Report from the Select Committee on Loans to Foreign States, together with the Proceedings of the Committee, Minutes of Evidence, Appendix and Index*, Parliamentary Papers 1875, XI, Parliament, House of Commons. London.
US Senate Hearings (1932): *Sale of Foreign Bonds or Securities in the United States*, Hearings Before the Committee on Finance, US Senate, 72nd Congress. Washington, DC.